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In the Supreme Court of the United States.

OCTOBER TERM, 1929.

No. 67.

ROBERT H. LUCAS, COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

AMERICAN CODE COMPANY, INCORPORATED.

BRIEF FOR RESPONDENT.

The Evening Post Job Printing Office, Inc., 154 Fulton St., New York, N. Y.

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OPINIONS BELOW.

The opinion of the United States Board of Tax Appeals (R. 7-9) is reported in 10 B. T. A. 476. That of the United States Circuit Court of Appeals for the Second Circuit (R. 14-18) is reported in 30 F. (2d) 222.

QUESTION PRESENTED.

Are damages for a Breach of Contract incurred and sustained on the date of the Breach, within the meaning of Section 234A of the Revenue Act of 1918, entitling a taxpayer, making income tax returns on the accrual basis, to take deduction therefor from income of the year in which the Breach occurred?

STATUTES INVOLVED.

This case involves the general law of contracts and Revenue Act of 1918, C. 18, 40 Stat. 1057, Secs. 234, 212 and 232.

"Sec. 234(a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *;

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise;

* * * * * *

Sec. 212(b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. * * *

Sec. 232 That in the case of a corporation subject to the tax imposed by section 230 the term "net income" means the gross income as defined in section 233 less the deductions allowed by section 234, and the net income shall be computed on the same basis as is provided in subdivision (b) of section 212 or in section 226.

SUMMARY OF ARGUMENT.

Where a taxpayer commits an act in a certain tax year which gives rise to a cause of action against it for Breach of Contract, all the events have occurred from which the taxpayer's liability is to be determined and the amount thereof fixed, because damages for Breach of Contract are suffered when the contract is broken and are assessed as of that date. Therefore, such taxpayer, whose regular method of accounting is an accrual basis, authorized by Section 212(b) of the Revenue Act of 1918, is entitled to accrue a reserve to cover its liability, which reserve is an expense or loss incurred or sustained within the meaning of Section 234(a) of said Revenue Act. The happening of the events which give rise to the liability and from which the amount of it is determined, fix the year, the income of which is affected by such liability and not those subsequent circumstances, unrelated to the business of a taxpayer or to those transactions which it carries on to produce income, such as the required action of officials, Boards or Courts, in determining the liability and fixing the amount, obviously affected as to the time of occurrence by the condition of calendars, the length of time given to consideration of a case, and similar circumstances.

ARGUMENT.

A LOSS OR EXPENSE ARISING FROM A BREACH OF CONTRACT IS INCURRED ON THE DATE OF THE BREACH, IS ASSESSED AS OF THAT DATE AND, UNDER THE REVENUE ACT OF 1918, IS DEDUCTIBLE IN THAT YEAR.

Section 212 of the Revenue Act of 1918 allows a taxpayer to file returns on an accrual basis if the books are so kept, and Section 234(a) of the same act permits a corporation to deduct from its gross income—

> "(1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. * * *
>
> "(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise. * * *"

Section 234, however, contains no provisions defining when an expense or a loss is "incurred" or "sustained", so that such a definition must be supplied by the application to the Revenue Act of General Rules of Law.

The expense or loss in this case arose from a Breach of Contract which occurred in May 1919. It is a cardinal principle of the law of contracts that damages for a breach *are suffered when the Contract is broken* and *are assessed as of that date.* This principle has been established not only in most State Jurisdictions but also in the Federal Courts. *Freer* v. *Denton,* 61 N. Y. 492; *Howard* v. *Daly,* 61 N. Y. 362; *Parker* v. *Russell,* 133 Mass. 74; *Roehm* v. *Horst,* 178 U. S. 1; *Pierce* v. *Tennessee Coal Co.,* 173 U. S. 1.

The case of *Parker* v. *Russell,* cited above, has been widely cited and followed in many states and has been ap-

proved in the Federal Courts. In this case it was said (pp. 75 and 76).

> "But if the breach has been such that the plaintiff has the right to treat the contract as absolutely and finally broken by the defendant, and he elects to so treat it, the damages are assessed as of a total breach of an entire contract. *Amos* v. *Oakley,* 131 Mass. 413; *Schell* v. *Plumb,* 55 N. Y. 592 (and other cases). Such damages are not special or prospective but are the damages naturally resulting from a total breach of the contract and *are suffered when the contract is broken and are assessed as of that time."* (The italics are ours.)

In *Pierce* v. *Tennessee Coal Co., supra,* there is found an exhaustive synopsis of the application of the rule of law under discussion in various jurisdictions. The opinion contains a particularly clear discussion and approval of the decision in *Parker* v. *Russell,* and as a conclusion holds (p. 16):

> "But he had the right to elect to treat the contract as absolutely and finally broken by the defendant; to maintain this action once for all as for a total breach of the entire contract and to recover all that he should have received in the future as well as in the past if the contract had been kept. In so doing, he would simply recover the value of the contract to him at the time of breach including all the damages, past or future, resulting from the total breach of the contract."

Applying this fundamental rule of Contract Law to the Sections of the Revenue Act of 1918, we find that the amount which respondent suffered as an expense or loss by reason of its Breach of Contract in 1919, was an allowable

deduction from its income of that year, in fact, was a necessary deduction in that year for one keeping its books and making its returns on an accrual basis, in order that the return clearly reflect the true income of the year.

The petitioner in his brief, admitting the correctness of the rule that damages for a Breach of Contract are suffered when the contract is broken and are assessed as of that time, argues that such rule is wholly inapplicable here, because it has been the consistent policy of the Commissioner, approved by the Courts, to disallow any accrued deduction for a business expense or loss until all the events have occurred which fix the amount of the expense or loss. The Revenue Act itself contains no such provision, the history of the administration of the various Revenue Acts discloses no such policy of enforcement, and the Courts have not by their decisions, established any such rule, but have decided to the contrary, particularly in those cases cited in petitioner's brief.

Since 1916 the machinery set up by the Commissioner of Internal Revenue, for the interpretation and enforcement of the Revenue Acts, has always provided for the making of Income Tax returns on an accrual basis, and for adjustment of accrued items not fixed in amount at the time of accrual, by means of claims for refund or additional assessment. It was recognized that in a business of any magnitude there are bound to be items properly relating to the income of a particular year which cannot be definitely ascertained by the time fixed for the filing of the year's return. In the 1916 Act the taxing statutes were changed to allow a corporation to make its returns upon the same

basis that its accounts were kept (if kept on other than actual receipts and disbursements basis). The Commissioner then promulgated Treasury Decision 2433 to interpret this change in the statute, ruling that it—

> "will be permissible for corporations which accrue on their books monthly or at other stated periods amounts sufficient to meet fixed annual or other charges, to deduct from their gross income the amounts so accrued, provided such accruals approximate as nearly as possible the actual liabilities for which the accruals are made, and provided that in cases wherein deductions are made on the accrual basis as hereinbefore indicated, income from fixed and determinable sources accruing to the corporations must be returned, for the purpose of the tax, on the same basis."

The deecision also permitted the deduction of reserves set up by a taxpayer, following a consistent accounting practice, to cover liabilities the "amount of which or date of maturity" were *not definitely determinable.*

This interpretation of the Statute by the Commissioner was approved by this Court in the case of *United States* v. *Anderson,* 269 U. S. 422, a case mainly relied on by petitioner as supporting his arguments. In this case the Court, after reciting the changes brought about by the 1916 Act and the Treasury Decision, above referred to, said:

> "We think that the statute was correctly interpreted by the Commissioner and that his decision referred to was consistent with its purpose and intent" (p. 438)

and that the purpose and intent of the 1916 Act—

> "was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period; and indeed, to require the tax return to be made on that basis, if the taxpayer failed or was unable to make the return on a strict receipts and disbursements basis" (p. 440).

In Article 111 of Regulations 45, promulgated by the Commissioner pursuant to the Revenue Act of 1918, we find that—

> "Each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return.

and

> "The expenses, liabilities, or deficit of one year can not be used to reduce the income of a subsequent year."

and

> "A person making returns on an accrual (accrued) basis has the right to deduct all authorized allowances, whether paid in cash or set up as a liability, and it follows that if he does not within any year pay or accrue certain of his expenses, interest, taxes or other charges, and makes no deduction therefor, he cannot deduct from the income of the next or any subsequent year any amounts then paid in liquidation of the previous year's liabilities."

and

> "If subsequently to its occurrence, however, a taxpayer first ascertains the amount of a loss sustained during a prior taxable year which has not been deducted from the gross income, he may render an amended return for such preceding taxable year, including such amount of loss in the deductions from gross income, and may file a claim for refund of the excess tax paid by reason of the failure to deduct such loss in the original return."

In later Regulations the Commissioner has even more clearly recognized the right to deduct reserves to cover unliquidated liabilities.

Article 112, Reg. 65 and 69 provided:

> "* * * A taxpayer has the right to deduct all authorized allowances, and it follows that if he does not within any year deduct certain of his expenses, losses, interest, taxes, or other charges, he can not deduct them from the income of the next nor any succeeding year. It is recognized, however, that particularly in a going business of any magnitude there are certain overlapping items both of income and deduction, and so long as these overlapping items do not materially distort the income they may be included in the year in which the taxpayer, pursuant to a consistent policy, takes them into his accounts. Judgments or other binding adjudication, such as decisions of referees and boards of review under workmen's compensation laws, on account of damages for patent infringement, personal injuries, or other cause, are deductible from gross income when the claim is so adjudicated or paid, unless taken under other methods of accounting which clearly reflect the correct deduc-

> tion, less any amount of such damages as may have been compensated for by insurance or otherwise. * * *".

The Courts also have repeatedly held either directly or by implication from the facts involved in a particular case, that, fixation of the amount of a loss is not a necessary condition precedent to the allowance of a reserve set up to cover it, so long as the loss has been "incurred" or "sustained" by the happening of the events which give rise to the liability and which are considered in the final determination of the amount thereof. An analysis of the cases cited by petitioner shows this and establishes that such cases are as a whole authorities supporting the respondent's contentions.

In *United States* v. *Anderson, supra,* two taxpayers were involved; in one case the taxpayer had, in 1916, set up a reserve for munitions taxes. The return for the tax was made in 1917 and the tax, *after revision and an additional assessment* was paid in 1917. In the other case a reserve for such taxes was set up in 1916 in the amount of $86,541.95. In 1917 the munitions tax was returned and *ultimately assessed and paid in* the sum of $112,419.54. In both cases the taxpayers deducted the amount of the tax in their 1917 returns and the Commissioner, taking a position exactly opposite to his position in this case, sought to compel the taxpayers to take the deductions in 1916. In neither case had the amount of the tax been fixed in 1916. And in both cases the reserve set up in 1916 did not correspond to the amount of the tax ultimately assessed by the Commissioner in 1917 requiring the happening of further "events",

using the word in the sense in which it is used in petitioner's arguments, before such final determination was had, to wit, the action of the Commissioner in revising the returns and fixing the tax. Nevertheless, the Commissioner claimed that the deduction must be taken in 1916 and was upheld by this Court. The Commissioner did not claim, as he has in this case, that the act of fixing and determining the tax in 1917 was an event which made the tax relate to 1917 income instead of 1916 income. He did claim that all the events which fixed the liability, if there was any, and all the events from which the amount of the tax could be determined had occurred in 1916, and hence such tax was related to 1916 business. This Court, in effect, held that in order for an expense or loss to be deductible in a certain year, all the events must have occurred from which the liability *is to be* determined and the amount thereof fixed. This is shown not only by the facts recited in the opinion and just referred to, but also by the approval, in the language of the opinion previously quoted, of the method promulgated for setting up and deducting reserves to cover liabilities the "amount of which or date of maturity" is not definitely determinable. In the *Anderson case* would denial of liability by the taxpayer by contesting the validity of the imposition of the tax, have so changed the facts that the Commissioner, or the Court, would have allowed the deduction in 1917, when the liability and the amount were definitely fixed? We think not. The events which give rise to the liability and from which the amount of it is determined fix the year whose income is affected thereby and not the subsequent events, controlled by the condition of Court calen-

dars, the length of time given to consideration of the case by the Courts, and similar circumstances, not related in any way to the business of a taxpayer or to those transactions which he carries on to produce income in the particular year in which the final determination is made.

The position taken by the Commissioner in this case is entirely inconsistent with his position in the *Anderson case,* and he attempts to deduce from that case a rule which is not there present or laid down, and which would be contrary to the contention which he advanced therein.

In the case of *Lewellyn* v. *Electric Reduction Co.,* 275 U. S. 243, cited by petitioner as supporting his argument, the taxpayer sought to deduct in 1918 the amount which it had prepaid in that year to a seller who had contracted to deliver merchandise to the taxpayer but had failed to do so. The taxpayer had not, however, elected to treat the contract as abandoned by the seller in 1918, but had in fact endeavored to get deliveries made and had succeeded in getting some deliveries as late as December in that year. There was, therefore, no Breach of Contract occurring in 1918. When the taxpayer did finally pursue his legal remedies he did not seek to recover damages for the seller's Breach of Contract, but only sought to recover from the seller the balance of the amount prepaid. There is, therefore, no parallel between that case and the case at bar, but the Court recognized that had the taxpayer elected to treat the contract as breached in 1918 as was his right, the result might have been different. (Quoting from p. 246):

> "We may assume also that upon the abandonment of the contract by the seller the buyer might have maintained an action to recover the balance of the

money which he had paid. But so far as appears from the record there had been no abandonment by the seller in 1918. Throughout that period the buyer was calling for deliveries and some were made as late as in December. The buyer's rights were upon a contract for the delivery of merchandise and were not a "debt" in either a technical or a colloquial sense. We conclude that if respondent's contract rights became worthless in 1918 he was not required to deduct his loss as a worthless debt under sub-section (5), but was entitled to deduct it under sub-section (4) as a loss sustained in that year."

The decision of the United States Court of Claims in *Malleable Iron Range Co.* v. *United States,* 62C, Cls. 425 and 65C, Cls. 441 cited in petitioner's brief, involved neither facts nor law similar to or applicable to our case. In the former case, the claimed deduction was based upon a judgment awarded for patent infringement occurring over a continuing period of six years (1905-1911). In the present case the deduction is based upon a breach of contract which occurred on a date in May, 1919. In the former case the taxpayer was not seeking to make the deduction in the year or years of the infringement, but in the year in which the judgment was rendered by the Trial Court. In our case the taxpayer did seek to make the deduction in the year in which the breach occurred, and the Court below, looking to the law of contracts for a definition of the time when damages for a breach are "incurred", found a well established principle that such damages are *"sustained when the contract is broken and are assessed as of that date"*, and applied such principle to the provisions of Section 234(a) Revenue Act of 1918, in accordance with the

contemplation of the whole Taxing Statute and the decision of this Court that the changes in the Taxing Statute made in 1916 were—

> "to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period;" *United States* v. *Anderson,* 269 U. S. 422 at page 440.

The Court of Claims in its first decision had before it incomplete findings of fact, and such expressions as "when the amount in question is in litigation it cannot be determined until the litigation is ended", contained in such decision (62C Cls. 425 at p. 432), are contrary to this court's decision in *United States* v. *Anderson, supra,* and are clearly dictum in the light of the opinion rendered after the case was remanded to it by this Court for additional findings, when it was disclosed that no such question was presented. The actual decision rendered in the case (65C Cls. 441) held that a taxpayer who had accrued on its books an amount equal to the security given to cover a judgment awarded for patent infringement, was entitled to deduct such accrual in the year in which the security was given *without waiting for final determination either as to the validity or amount of the judgment* by higher courts to which appeal had been taken. Only in this latter respect is there any similarity with the case at bar, and in this respect there is complete accord with the principal laid down in the *Anderson case* and contended for by the respondent in this case.

Becker Bros. v. *United States,* 7 F. (2d) 3, involved similar facts and resulted in the same decision as the second *Malleable Iron Range decision.*

In *Consolidated Tea Co.* v. *Bowers,* 19 F. (2d) 382, a district court concluded that the rendering of a judgment is not the controlling factor in determining when a loss is sustained. A decision which lends support to our arguments and which is certainly not an authority for petitioner's contentions. In this case, based on a claim for commissions earned, the reserve was not made in the year or years when the commissions were earned, but was made in the year in which the judgment was rendered. This judgment was taken up on appeal and, unlike the last two cases discussed, no bond or security for the judgment was furnished. The only question presented was whether or not the deduction could be made in the year when the judgment was rendered.

The Court said in its opinion, page 384:

> "It seems to me that the time of the mere rendering of a judgment is not the controlling factor in determining when a loss is sustained * * *. From a tax income standpoint, both logical and practical reasons seem to me to support the conclusion that a loss should be deductible not in the year when the judgment was rendered, but in the year when the claim was adjudicated to be final and definite, or possibly under certain circumstances in the year when the claim originated." * * *
>
> "* * * while it is not necessary in deciding this case, and is probably inadvisable with the present record to determine whether the loss in question may have been deductible at the time the services were rendered or the damage occurred upon which the judg-

> ment against the tea company was founded, or was deductible when the judgment was affirmed and paid, I think it is clear that it was not deductible in 1919, and accordingly a verdict is directed in favor of the defendant."

As the taxpayer made no claim for right to deduct in the year when the claim arose, and as no security seems to have been given to cover the judgment, this decision is consistent with the cases previously discussed and cannot be construed as supporting petitioner's contentions. In fact the dicta in the Court's opinion is in support of respondent's arguments.

In the cases of *S. Naitove & Co.* v. *Commissioner,* 32 F. (2d) 949, and *Kaufmann Department Stores, Inc.,* 11 B. T. A. 949 (C. C. A. 3d), 34 F. (2d) 257, the facts disclose that all the events had not occurred in the year or years in which deductions were sought, from which the liability could be determined. In the former case an agreement for the payment of a bonus to certain employees provided that the amount should remain in the business for five years subject to the risks of the business and that if any employee was meanwhile discharged or withdrew from the employment his right to the bonus was to revert to the employer. It can thus be seen that the occurrence of events subsequent to any particular year affected an employee's right to a bonus or the amount which he might get. As the Court said (p. 950):

> "The accounts under the agreement were kept on the books of appellant on an accrual basis, under which system those items of expense could not accrue until all the events occurred from which liability could be determined and become fixed."

and pages 950, 951:

> "Construing the provisions of the income tax law here involved we are of the opinion that under the accrual system of accounting income may be said to be accrued when it is definitely received, and that likewise liabilities or expenses will be considered to have accrued only when the events have occurred from which liability or expense can be determined and fixed, even though payment is not yet due. This principle was involved in *United States* v. *Anderson, et al.* 269 U. S. 422."

and page 951:

> "The resolution in the present case amounts to nothing more than an offer to pay additional compensation to certain employees under a conditional contract which could only mature into an obligation and become binding upon appellant company on complete performance by its employees of the acts called for therein, and which could not be ascertained until the expiration of the five year period fixed by the agreement."

Similar facts were present in the *Kaufmann decision* in which the Board of Tax Appeals pointed out that—

> "The *Block & Kohner* and *Anderson* cases are, we think, ones in which the right to compensation has already accrued or a liability to pay has been incurred and only the enjoyment of the compensation is postponed, or the amount to be paid is subject to be cut down or possibly wiped out by later events, whereas, in the present case * * * we are of the opinion that neither the right to receive the compensation nor the liability for its payment came into existence until the termination of the contract, * * *" (p. 957).

All the cases which we have discussed are consistent with each other and with the decision of the Court below in this case. In *Lewellyn* v. *Electric Reduction Co.*, 275 U. S. 243, the Court held that there was no evidence establishing a Breach of Contract in 1918, the year in which deduction was sought, and that, therefore, allowance in that year must be denied. In *Malleable Iron Range Co.* v. *United States,* 65C Cls. 441, it was held that the taxpayer, having parted with security to cover a judgment rendered, could take the deduction in the year in which the security was given, without waiting until the validity or amount of the judgment had been determined on appeal to higher Courts. In *Consolidated Tea Co.* v. *Bowers,* 19 F. (2d) 382, where the question presented involved only whether the deduction could be taken in the year when judgment was rendered (no security appearing to have been given for the judgment) it was held that the rendition of the judgment was not the controlling event but rather the affirmance thereof, or *"under certain circumstances"*, the origination of the claim. In *S. Naitove & Co.* v. *Commissioner,* 32 F. (2d) 949, and *Kaufmann Department Stores, Inc.,* 11 B. T. A. 949, while no Breach of Contract was involved it was pointed out that the contracts under which claimed deductions arose, were still pending and required further acts of performance before all events would have occurred, from which deduction could be determined and fixed. In the former case the Court, on the authority of *United States* v. *Anderson,* stated the rule to be as we have herein contended. In the latter case the distinction between it and cases such as the one here at issue was clearly pointed out. And finally, in *United States* v.

Anderson, 269 U. S. 422, it was held that a Munitions Tax had accrued in 1916 and, therefore, must be deducted from income of that year although such tax was not actually determined and fixed until after the Commissioner of Internal Revenue had acted upon and revised the tax return made in 1917, thus confirming the rule contended for herein that the year in which deduction is made is controlled by the happening of the events from which the liability is to be determined and the amount thereof fixed.

The Board of Tax Appeals and the Commissioner himself have recognized and applied the ruling for which we herein contend. Appeal of *Producers Fuel Co.,* 1 B. T. A. 202. The Commissioner acquiesced in this decision in which it was held (p. 207):

> "The taxpayer's liability for damages on account of the breach of these contracts was a liability actually incurred at the date of the breach."

In later decisions, however, the Board attempted to distinguish its previous decision and has created a confusion in the administration of the Income Tax law, which has been clarified by the decision of the Circuit Court of Appeals in this case. The inconsistencies of these decisions of the Board is fully discussed in the opinion of the Court below. (R. 17.)

There is no weight in petitioner's argument that the decision of the Court below in this case unsettles or overturns departmental practice, or would result in uncertainty and inconvenience in the Administration of the Income Tax law. We think it is matter of common knowledge that a great majority of income tax returns are revised in later

years in the light of facts then finally determined. The same absence of exact and final determination would have been present if the taxpayer in making his tax return had actually conformed to the decision as rendered in the cases cited, such as the *Anderson case,* and the *Malleable Iron Range case.* It has become the settled policy of Congress, as evidenced by its change in the 1916 Revenue Act, of the Commissioner, and of the Courts, to enact, enforce and interpret the Revenue Acts so as to have the tax ultimately based upon the year's true income in accordance with sound and safe business practices, and recognized accounting principles, regardless of whether or not the tax return itself, could, at the time when it had to be rendered, be an instrument of mathematical and factual correctness.

CONCLUSION.

The decision of the Circuit Court of Appeals gives effect to a recognized principle of contract law, is in full accordance with the provisions of the Revenue Act which it interprets, and is entirely consistent with prior applicable decisions of this Court and other Courts. It is submitted that such decision should be affirmed.

Respectfully submitted,

CLARK H. HEBNER,
Counsel for Respondent.